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The Discipline of Institutions and the Disciplining of Banks

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I. INTRODUCTION

Banks provide nice fodder for the study of economic institutions. As institutions, banks[1] have come a long way from the *banco* or benches where money changers carried out their trade to Citicorp Center and One Chase Manhattan Plaza through which millions of dollars find their way each day. The interesting thing about economic institutions is that they grow, they change, they contract, they fail to change; eventually norms emerge and guide behavior. These norms are carved in stone—they persist in the face of challenges and they adapt at their own pace, and, sometimes, when faced with unprecedented peril or the whims of a new crop of leaders, these norms are thrown out the window, stone, carvings and all. Banks are an interesting sort of economic institution because they produce many externalities. When banks sneeze, economies contract, depositors panic, and markets get their supply and demand curves all shifted about. The ongoing debate on bank regulation and market discipline of banks is carried out with these externalities in mind.[2]

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[1]*See* THE OXFORD ENGLISH DICTIONARY (2d ed. 1989).

[2]For a discussion of the bank regulation-market discipline debate, see Helen A. Garten, *Market Discipline Revisited*, 14 ANN. REV. BANKING L. 187 (1995); Helen A. Garten, *Whatever Happened to Market Discipline of Banks?*, 1991 ANN. SURV. AM. L. 749; Helen A. Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 FORDHAM L. REV. 501 (1989); Helen A. Garten, *What Price Bank Failure?*, 50 OHIO ST. L.J. 1159 (1989); Helen A. Garten, *Banking on the Market: Relying on Depositors*

This Essay focuses on the issue of institutional change.[3] After all, at its foundations this is what the bank regulation/market discipline debate is about. Bank regulators (including Congress) have approached banking regulation in much the same way that a cat approaches a marble on a living room floor: the approach is slow and cautious; the cat stares at the marble and then softly taps it with its paw; as the marble rolls all the way across the living room floor, the cat at first sits there mesmerized and then rapidly rushes back to the marble; then another cautious look at the marble and another soft pat with the paw and once again the marble rushes to the other side of the room. And so on and so on until exhaustion or boredom hits.

Bank regulators do the same. After periods of bank failures and financial stress, regulators tighten up; they go in and close down banks, increase their monitoring of surviving institutions and recast regulations so as to avoid future troubles.[4] Then, "out of the blue," they have a "credit crunch" on their hands.[5] They scratch their heads and go at it again, this time

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to Control Bank Risks, 4 YALE J. ON REG. 129 (1986); Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153 (1988); Alfred Dennis Mathewson, *From Confidential Supervision to Market Discipline: The Role of Disclosure in the Regulation of Commercial Banks*, 11 J. CORP. L. 139 (1986); David G. Oedel, *Private Interbank Discipline*, 16 HARV. J.L. & PUB. POL'Y 327 (1993).

[3]For a discussion of institutional change, see JACK KNIGHT, INSTITUTIONS AND SOCIAL CONFLICT (1992); DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1990); Geoffrey M. Hodgson, *Evolution and Institutional Change: On the Nature of Selection in Biology and Economics*, *in* RATIONALITY, INSTITUTIONS AND ECONOMIC METHODOLOGY 222 (Uskali Mäki et al. eds., 1993); Margaret Levi, *A Logic of Institutional Change*, *in* THE LIMITS OF RATIONALITY 402 (Karen Schweers Cook & Margaret Levi eds., 1990).

[4]*See, e.g.*, Lowell L. Bryan, *Banking Crisis Is Different and Could Be More Serious*, AM. BANKER, Aug. 1, 1990, at 4 ("Regulators have focused on the similarity between S&Ls and banks. No one wants to be held responsible for a repeat of the S&L crisis. Their first impulse has been to toughen lending standards and raise capital requirements.").

[5]One journalist explains:

> Such conservative regulation is appropriate for all government-insured depositories, and it should have been started several years ago. In the short term, however, we face a . . . devastating credit crunch, particularly for small businesses, midsize companies, and builders . . . . Regulators are now aware of these risks. In their public discussions with bankers they have urged them to keep funds flowing to all creditworthy borrowers. The regulators face an unenviable task. They are walking a tightrope between being too strict and not strict enough.

Bryan, *supra* note 4, at 4; *see also* Richard C. Breeden & William M. Isaac, *Thank Basel for Credit Crunch*, WALL ST. J., Nov. 4, 1992, at A14; David Wessel, *As Banks Get Tough With Borrowers, Fears of a Recession Rise*, WALL ST. J., Mar. 22, 1990, at A1.

relaxing monitoring, encouraging risk-taking, cutting down on required paper work.[6] These cycles are not uncommon; we experienced them during the 1930s and again in the 1980s and early 1990s; at various other times we have experienced them in less dramatic fashion.

So regulators and academics shop around for a better way of doing things, and in comes market discipline. But as was mentioned above, the market by itself will not do, given that the business of banking produces certain negative externalities. So regulators set out to hand-tailor market discipline. But, as they have come to realize, disciplining the market turns out to be a very tricky enterprise.

We can distinguish three ways of disciplining banks: (i) a pure regulatory approach; (ii) a pure market approach; and (iii) a hybrid market/regulatory approach. The latter can be divided into two types: (i) using regulation to supplement the discipline provided by the market; and (ii) using regulation to change the structure of market discipline—i.e., to change the incentives of market participants and the institutional structures in which they operate.

This Essay contends that some of the puzzles surrounding regulatory and market constraints of banks begin to disappear if we pay closer attention to the institutional structure in which this activity takes place. The usual questions asked by participants in this debate—i.e., whether market discipline is necessary, and if so, who should impose it[7]—cannot be properly answered without a better understanding of how economic institutions emerge and change. In other words, we need to understand what is it about the institutional structure that makes it so hard to discipline banks.

II. THE NATURE OF INSTITUTIONS

We must begin with some foundations. The term "institution" is used in a variety of contexts to refer to different things. For our purposes, there is no need to come up with an all-encompassing definition that would satisfy Coaseans and Marxists alike. I will use the word "institution" to mean those constraints or "rules of the game" that affect human interaction.[8]

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[6]*See, e.g.*, Kenneth H. Bacon, *Clinton Unveils Program to Ease Credit Crunch*, WALL ST. J., Mar. 11, 1993, at A3.

[7]*See, e.g.*, Garten, *Market Discipline Revisited*, *supra* note 2.

[8]*See* NORTH, *supra* note 3, at 3 ("Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction.").

This definition by itself does not give us enough friction to stand firmly and separate "institutions" from the rest of existence.

We can further define the term "institution" with some examples and a bit of contrast. Rules, norms, codes, laws, statutes are all examples of institutions—they help constrain human action. The mere existence of institutions is not enough to constrain human actors. Habit, acquiescence, indoctrination, self-interested action, and the threat of pain or punishment all help give some bite to institutions. We can distinguish between formal institutions, such as laws, and informal ones, such as norms—the former are more established and carry with them a certain amount of legitimacy in the use of punishment. By constraining human behavior, institutions help resolve conflict and foster cooperation. This helps explain why individuals are often quite content to comply with institutions and to put a lot of time and effort into setting them up.

There is no inherent reason why we should take a term with such good standing and give it all this baggage to carry. But recently economists and political scientists have latched on to the term in order to help explain why individuals sometimes fail to behave according to the nicely set out rules of rational choice theory. Very generally, rational choice theory provides that individuals adopt certain preference orderings among different bundles of goods and then set out to choose those actions that maximize the chances of acquiring the preferred bundle.[9] When individuals choose bundles of goods that, according to their orderings, are less preferred, questions arise. Is this individual acting irrationally? Yes, by definition. Well, then, does the theory of rational choice capture all those bits of reality that we want it to capture? And this is where "institutions" come in. The individual may have chosen the less-preferred bundle because she was somehow constrained by certain norms or by other informal constraints, or maybe her incentives were influenced by certain laws or other formal constraints.

Once institutions are established they acquire a sort of inertia of their own—it becomes hard to change them. This institutional path-dependence helps explain why economic actors sometimes act in ways that can be termed "irrational." Furthermore, institutions emerge and change not solely through planning and intentional intervention. Chance, historical contingencies and evolutionary forces all help cast, reshape and bury

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[9] *See* THE THEORY OF CHOICE 3-7 (Shaun Hargreaves Heap et al. eds., 1992); Jon Elster, *Introduction* to RATIONAL CHOICE 1, 4-5 (Jon Elster ed., 1986).

institutions. So we must focus on the margins, on those actions that indirectly affect institutional development and change. We must also focus on history. All this makes analysis quite unruly. The nice curves of neoclassical economics, carefully assumed and easily differentiable, become tangential to the analysis. They provide some guidance, some right answers, but they also provide puzzles that require other sorts of answers.

III. DISCIPLINE AND THE INSTITUTIONS OF BANKING

The institutions of banking affect how those involved in the industry—customers, investors, managers, and regulators—behave, how they compete and cooperate with each other. There are certain norms, certain "rules of the game" that affect these interactions. History is obviously important: 1929, J.P. Morgan, the runs, the busts have all cast their shadow. Layer upon layer of regulations have been adopted and modified over time. Competitors have arisen and disappeared. They have crossed natural and manufactured barriers and have left their marks on institutions and on the way business is conducted. None of this is new or surprising. But it requires much more analysis than it has been given.

This Essay is particularly concerned with a narrow set of questions: Why has it proven so difficult to effectively discipline banks? What institutions stand in the way? What institutions react and reverberate when market players and regulators make themselves heard?

This Part addresses four institutional issues that need to be better understood and taken into account if we are to be successful in devising a structure to effectively discipline banks: (i) the opacity of banking institutions; (ii) the herding effect in the banking industry; (iii) the overabundance of monitors; and (iv) the fragility of bank managers' human capital.

A. The Opacity of Banking Institutions

We can divide banks into the "thin banks" of economists and the "thick banks" of regulators, lawyers, and market participants. To economists, banks are financial intermediaries in the business of buying, selling and otherwise transforming financial assets.[10] But as James Tobin points out:

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[10] *See generally* IVAN C. JOHNSON & WILLIAM W. ROBERTS, MONEY AND BANKING: A MARKET-ORIENTED APPROACH 165 (3d ed. 1988); FREDERIC S. MISHKIN, THE ECONOMICS OF MONEY, BANKING, AND FINANCIAL MARKETS 9 (2d ed. 1989).

> Economists start from the presumption that financial activities are epiphenomena, that they create a veil obscuring to superficial observers an underlying reality which they do not affect .... [E]conomist[s] can pierce the veil and see that the values of financial assets are just those of the outside assets to which they are ultimately claims, no matter how circuitous the path from the one to the other.[11]

While this picture is helpful if we are trying to understand the economic rationale behind financial intermediation, the banks and transactions with which we are concerned prove more opaque to the outside observer.

This opacity of banks is a function of a number of institutional contingencies. We can divide these into four types: (i) financial; (ii) structural; (iii) regulatory; and (iv) historical. The financial statements of banks are hard to decipher and hard to compare with those of other industries. This by itself should not be a problem, since one can always learn how to read them and one can always compare financial statements within the industry. However, the nature of a bank's assets and liabilities—the fact that they are mostly paper—makes it easier to "hide" items in financial statements (or off of them). For example, a recurrent problem when foreign banks try to carry out public offerings in the United States is their reluctance to disclose their secret reserves and open other financial closets. Another reason why ascertaining the financial status of banks is so difficult is because of their complicated capital structures.[12]

There are certain structural contingencies that also contribute to the opacity of banks. The most important is that banks are generally controlled by bank holding companies.[13] This makes it tempting for holding companies

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[11]James Tobin, *Financial Intermediaries*, *in* THE NEW PALGRAVE: FINANCE 35, 41 (John Eatwell et al. eds., 1989).

[12]For an illustration of the complicated capital structure of banks and the difficulties of adopting simple and straightforward disclosure requirements, see Statistical Disclosure by Bank Holding Companies, Fed. Sec. L. Rep. (CCH) ¶ 3827, at 3314 (1993).

[13]*See* Dean F. Amel et al., *Trends in Banking Structure since the Mid 1970s*, 75 Fed. Res. Bull. 120, 125 (1989) (stating that by 1987, multibank bank holding companies held 70% of banking assets; one-bank bank holding companies held 21% of banking assets; and independent banks held only 9% of banking assets; and noting that over 50% of banks were either multibank or one-bank bank holding companies.) *See also* MISHKIN, *supra* note 10, at 197 (90% of all commercial bank deposits are held in banks owned by holding companies).

For a discussion of regulatory requirements for bank holding companies, see Bank Holding Company Act, 12 U.S.C. §§ 1841-1848 (1988 & Supp. V 1993).

to shift around assets and liabilities and to cross subsidize their businesses. This is, of course, one of the reasons for the regulatory constraints on the types of business in which bank holding companies can engage. Related to this issue is the growing competitive pressure on banks by other types of financial intermediaries and other providers of investment vehicles. This has led to pressure to expressly or implicitly blur the line between what a bank can do and cannot do and between what banks now look like and what "the new and improved banks of the future" should look like.

Layered over the financial and structural contingencies is the regulatory structure. One reaction to the opacity of banks is to enact regulation to increase reporting requirements by banks and to increase regulatory monitoring. But the more regulation, the more monitoring, the more requirements that need to be understood, interpreted, and complied with, the more complicated and opaque that banking institutions become. It is as if we had a pair of glasses on and could not see very clearly, and proceeded to place five more pairs of glasses on top of the first one. After a while things become quite blurry. Congress has begun to understand this phenomena. Recently it adopted the Riegle Community Development and Regulatory Improvement Act of 1994, providing for ways to simplify regulation, cut the required paperwork and simplify the monitoring structure.[14]

An important aspect of the institutional analysis of banks is the fact that history matters. The opacity of banks has developed over time as banks, regulators, depositors and investors have reacted to different financial downturns, large bankruptcies, runs on banks, and new competitors. The institutions that emerged out of these historical contingencies were not always planned or well thought out. And each new level of institutions was layered on top of older ones. As mentioned above, one of the issues that needs to be addressed when looking at institutional frameworks is institutional path-dependence.

The opacity of banks matters for a number of reasons. For one thing, it makes it harder and more expensive for depositors, investors and regulators to monitor the actions of bank managers;[15] in particular, it makes it costlier

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[14] *See* Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, §§ 303-305, 108 Stat. 2160, 2215-16 (to be codified at 12 U.S.C. §§ 4803, 4804, 1820 respectively).

[15] For a discussion of special concerns involved in monitoring financial institutions, see SANKARSHAN ACHARYA & GREGORY F. UDELL, MONITORING FINANCIAL INSTITUTIONS (New York University Salomon Brothers Center Working Paper No. S-92-3, Jan. 1992).

to acquire and verify information regarding managerial action. Second, it creates a sort of lag-time between the actions of managers and the time when those actions are evaluated. This encourages greater risk-taking, since it allows for some lag time for managers to correct any tactical mistakes before the misguided actions are detected.

B. The Herding Effect

Another institutional feature that makes it harder to discipline banks is the existence of a certain "herding effect" in the banking industry. The herding effect arises because, as in the defense industry during the Cold War, the economic importance of the banking industry and the effects of bank failure on other industries make it harder for regulators to carry out harsh disciplining on the industry as a whole at any one time.[16] As a result, individual banks have the incentive to react to the signals of other banks without taking into full account the regulatory repercussions. Another way of describing the herding effect is that when a large sector of the industry has already undertaken certain actions, disciplining banks may produce negative externalities that exceed the benefits of disciplining the banks to begin with.[17]

For example, if a bank is thinking of whether to engage in an activity that may have some negative regulatory effects, or that is unduly risky, it will look around to see if other banks are doing the same thing. If they are, the first bank may be encouraged to join the "herd" and carry out this activity. One of the reasons that this herding effect arises is due to the opacity of bank institutions and the fact that it is harder for those outside the industry to take into full account the actions of each individual bank than it is for insiders in the industry to receive and process the signals of

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[16]For a discussion of the herding effect in the banking industry, see Arvind K. Jain & Satyadev Gupta, *Some Evidence on "Herding" Behavior of U.S. Banks*, 19 J. MONEY CREDIT & BANKING 78–89 (1987). For discussions of herding in other markets, see JOSEF LAKONISHOK ET AL., DO INSTITUTIONAL INVESTORS DESTABILIZE STOCK PRICES? EVIDENCE ON HERDING AND FEEDBACK TRADING (National Bureau of Economic Research Working Paper No. 3846); RICHARD ZECKHAUSER ET AL., NONRATIONAL ACTORS AND FINANCIAL MARKET BEHAVIOR 24 (National Bureau of Economic Research Working Paper No. 3731).

[17]A couple of examples of what could be construed as the herding effect are the following: the great increase in bank loans to Latin American countries during the 1970s and 1980s, and the overinvestment in real estate loans by banks during the 1980s.

other banks. So by the time regulators realize that banks have undertaken certain activities that are unduly risky or that raise regulatory concerns, it may be harder for them to take action to constrain banks' behavior. Thus, the herding effect may make it harder for regulators both to enforce already-enacted regulation, and also to ascertain that the industry has moved into risky ventures that require further regulation.

C. The Overabundance of Monitors

There are a number of potential monitors of banks, including depositors, other creditors (such as holders of bank debt securities), shareholders, and government regulators.[18] While at first blush it may seem that having so many potential monitors is beneficial, having too many monitors can pose a number of problems. The greater the number of monitors, the greater the chance that each will expect that somebody else will carry out the monitoring; thus, the greater the free-rider problem.

The free rider problem is exacerbated by the fact that there is one dominant monitor—the government—that for structural reasons cannot free ride on the others, but which for statutory reasons can only intervene in certain specific situations. So, while regulators will be able to overcome the free rider problem when they are acting under regulatory strictures, other potential monitors will be hesitant to intervene if they think that the government or another monitor will expend the costs of monitoring. Three considerations will effect the level of monitoring in this context: (i) the clearer the government "signal" that it is not going to intervene, the more likely it will be that another monitor will intervene during a particular period; (ii) the clearer this signal, however, the less effective the government monitoring will be, given that the bank managers will be able to anticipate the regulator's visit;[19] and (iii) each of the potential monitors will have different costs of "exiting"—taking their deposits or capital someplace else.[20]

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[18] *See, e.g.*, Garten, *Market Discipline Revisited*, *supra* note 2, at 187.

[19] One can view the relationship between the bank managers and the regulators as a bargaining game where the regulators will have a bargaining advantage if the managers do not have access to information regarding their monitoring strategy. For a discussion of bargaining, see generally John C. Harsanyi, *Bargaining*, *in* THE NEW PALGRAVE: GAME THEORY 54 (John Eatwell et al. eds., 1989) and Manuel A. Utset, *Towards a Bargaining Theory of the Firm*, 80 CORNELL L. REV. ____ (forthcoming 1995).

[20] For a discussion of the exit/voice dichotomy, see ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY (1970). *See also* John C. Coffee Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991).

Having multiple monitors may, in certain circumstances, lead to inefficient monitoring (i.e., overmonitoring), since it makes it harder for each monitor to ascertain whether any other party is actually monitoring. Such redundant monitoring may occur especially in situations where a bank is under actual or perceived financial difficulty. The level of monitoring will also depend on the relative costs to the parties of monitoring and disciplining as opposed to using their "exit" strategy: as a bank approaches perceived financial trouble, it will become costlier for investors (other than depositors) to exit. This is because other potential investors will discount the value of the investment vehicle to take into account the additional perceived risk. Depositors will have their exit strategy protected by federal insurance, even though the timing of that exit may be delayed by regulators.

Another problem is that monitors may have conflicting interests. Monitors engage in monitoring and disciplining activities that favor their particular interests, and hurt those of the other monitors. In other words, monitors act strategically to the extent that they can increase distributions to themselves.[21]

This conflict of interest among monitors is exacerbated by the fact that government regulators have principally focused on protecting the interests of one set of monitors—the depositors.[22] The government has this particular bias because if banks fail, the government's major cost will be compensating depositors insured through the Federal Deposit Insurance Corporation. These different monitors, however, will still have an interest in trying to lobby regulators to intervene.[23] This problem is made more severe by the fact that now, in many cases, there are different regulatory agencies that have jurisdiction over particular banking entities. Congress has recently adopted a statute to try to diminish these multiple levels of regulators.[24]

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[21]For a discussion of distributive bargaining and conflict, see generally Robert Cooter, *The Cost of Coase*, 11 J. LEGAL STUD. 1 (1982).

[22]An example of legislation that protects the interests of depositors is the Federal Deposit Insurance Corporation Act § 8, 12 U.S.C. §§ 462a-1, 1811–1831 (1988).

[23]For a discussion of rent seeking, see THE POLITICAL ECONOMY OF RENT-SEEKING (Charles K. Rowley et al. eds., 1988) and TOWARD A THEORY OF THE RENT-SEEKING SOCIETY (James M. Buchanan et al. eds., 1980).

[24]*See* Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, § 305, 108 Stat. 2160, 2216 (to be codified at 12 U.S.C. § 1820).

Of course, not all of the monitoring concerns I have identified will be present in every case; the important thing to recognize is the potential problems and the contexts in which they may arise. For example, as banks get closer to insolvency, one might see over-monitoring, while in times in which a bank's financial trouble is not apparent, under-monitoring may occur.

D. The Fragility of Bank Managers' Human Capital

In certain ways, bank managers are no different from managers in any other industry. They are hired to manage the day-to-day affairs of business, and certain mechanisms encourage them to act independently, to take risks when appropriate, and to make any other decisions required. Those who invest in the enterprise have an incentive to encourage managers to act with this kind of independence.[25] As in other industries, however, bank managers will impose certain agency costs on the investors, for whom they are acting as agents.[26]

But banks pose additional problems for analysis.[27] This is because the agency role of bank managers is not as well-defined as that of managers in other industries; in other words, unlike in regular corporations, where managers can be said to be acting as agents of the shareholders alone, in banks the existence of depositors, as well as that of government regulators, makes it harder to define a clear-cut agency relationship. This point is of course related to the overabundance-of-monitors issue, discussed above.

As is the case in other industries, bank managers find it hard to diversify their human capital.[28] If bank managers are fired, their investment in institution-specific knowledge is lost.[29] Furthermore, their major source of

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[25]For example, one of the rationales for the "business judgment rule" in corporate law is to encourage this kind of independence by managers. *See generally* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

[26]*See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

[27]*See generally* Timothy H. Hannan & Ferdinand Mavinga, *Expense Preference and Management Control: The Case of the Banking Firm*, 11 BELL J. ECON. 671 (1980).

[28]*See generally* GARY S. BECKER, HUMAN CAPITAL (1993); Gary S. Becker, *Investment in Human Capital: A Theoretical Analysis*, 70 J. POL. ECON. 9 (Supp. 1962).

[29]For a discussion of asset specificity, see OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985).

income is also lost. Their inability to diversify their human capital will make the managers more risk averse.

This Essay contends that, in banking, the issue of investment in human capital by managers is more complicated than in other industries. This is for a number of reasons. First, bank regulators are able to overcome the collective action problem generally faced by monitors in other industries. Banking regulators can effectively punish managers. Of course, the most obvious means of disciplining a manager is by causing his dismissal; this will affect the manager's reputation and her ability to find another job in the banking industry. Furthermore, regulators can sometimes legally preclude certain fired or dismissed managers from engaging in the banking business in the future. In addition, because bank managers operate in a highly regulated environment, they must invest heavily in industry-specific knowledge about regulations. The investment in such knowledge is lost if a bank manager is forced to seek employment in another industry.

As a result of these institutional peculiarities of the banking industry, managers' investment in human capital is more fragile than in other industries. Thus, bank managers will tend to overreact when regulators send them signals as to their intentions. Regulators, of course, understand that the role of managers is to handle the day-to-day affairs of the company, and that regulators should not be involved in micromanaging banks. In times when regulators perceive that a bank is undergoing financial trouble, however, regulators will become more involved in the particular affairs of that bank, and will send clear signals to the managers about how they should alter their behavior. Managers, realizing that their investment in human capital will be lost completely if they lose their jobs, will pay close attention to regulators' signals, in some cases becoming much more cautious than the regulators intended.[30] This problem is exacerbated by the fact that we have an overabundance of monitors who will try to interfere and try to cause regulators to intervene in cases where they believe that their investment is even somewhat threatened.

This, of course, gives us one side of the story. As mentioned above, there are two other institutional features of banks that will effect the behavior of managers: namely, the opacity of banks and the herding effect. These two features allow managers, in certain cases, to act relatively unfettered. Thus, bank managers in these situations will have an incentive to take riskier action than they would if their actions were more transparent or if the

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[30] *See* Bryan, *supra* note 4, at 4.

herding effect did not shelter them to some degree from regulatory constraint. Thus, in times when the banking industry as a whole is doing well, or when it is not apparent that particular banks are facing financial trouble, bank managers may overinvest in risky transactions. As mentioned above, there will be a lag between the time when managers realize that a bank is in financial trouble, and the time when regulators or other outside monitors come to the same conclusion. During this period, bank managers may have even greater incentives to take additional risks, in the hopes that riskier transactions will lead to positive returns that will bring the bank back to financial security.

Once the regulators realize the situation, and recognize that a number of banks are facing the same type of problem because of downturns in the economies of particular geographic regions where the banks had heavy loan exposure, they will intervene and begin to send clear-cut signals to managers to change their ways. Thus we come full circle, and have one explanation of why in the past we have seen polar changes in bank manager behavior—why at times managers have extended credit freely and at other times have taken very conservative positions with their loan portfolios.

IV. IMPLICATIONS OF OUR ANALYSIS

As we have seen, focusing on the institutional framework in which banks operate allows us to clear up some of the puzzles regarding the effectiveness, or ineffectiveness, of market and regulatory discipline. From this we can conclude a number of things. First, we need to recognize the coarseness of these institutions and of market and regulatory discipline. In other words, it is very hard to design regulatory policies that are sensitive to what is actually going on. In other words, "[w]e feel as if we had to repair a torn spider's web with our fingers."[31]

Second, historical contingencies and the path-dependence of banking institutions must be factored into any analysis. Furthermore, when trying to come up with effective ways of dealing with banks, regulators must keep in mind banks' opacity and how additional regulation may have the unintended effect of making banks more opaque. Regulators should also recognize the herding effect and its tendency to dilute the impact of regulations.

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[31] LUDWIG WITTGENSTEIN, PHILOSOPHICAL INVESTIGATIONS I:106 (1953).

By the same token, we cannot always assume that increasing the number of potential monitors will produce efficient results. In analyzing a monitoring situation and creating incentives (and disincentives) to monitor, we need to take the institutional context into account. Finally, regulators and market participants should take into account that the nature of the human capital investment of bank managers is different from that of managers in less regulated industries.

This Essay began by trying to ascertain why disciplining banks is such a difficult task. The wide swings in bank behavior—from excessive risk taking to excessive caution—may be better explained if we focus on the institutional context in which market and regulatory discipline is carried out. The opacity of banks, the herding effect in the banking industry, the overabundance of monitors and the fragility of bank managers' human capital help us understand these oscillations in behavior. If regulators and market participants want to tailor their disciplining to achieve specific behavioral changes, they will have to take these institutional features into account.